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The Post-QE World of Unsustainable Growth

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We are now entering a new investment era, a post-quantitative easing ("QE") period of subdued nominal growth and returns. The forces defining this period have come into focus now that the dust of the financial crisis has settled and the dramatic policy responses, most notably QE, have run their course. The stalling out of some major global growth engines, like the extraordinary economic ascent of China and globalization of trade, and changing demographics have left us on a path of very low-single-digit nominal GDP growth. The IMF, which recently revised their 2016 GDP forecast down, has characterized the world economy as "too slow for too long". In that context investors will struggle, especially those seeking growth. In aggregate, companies will have trouble growing their revenues, and leveraging that low base to higher profits will be challenging, especially as we are likely near a cyclical peak in corporate margins and profits.

China's contribution to Global growth over the past few decades has been unprecedented. From a base of just over $1 trillion 15 years ago, China has grown, without interruption, to over $11 trillion and now represents close to 15% of global GDP. That has added about a quarter of total global GDP growth and has been a major force behind the expansion of world trade. Whether you believe official data or not, have faith in The Party to successfully steer that economy or not, the law of large numbers suggests China slows and there are likely to be bumps along the way. With the reduction in the growth opportunity, policymakers will try to reserve much of that to local interests leaving less for outsiders. It has become apparent recently that other major developing economies, i.e. Russia and Brazil, were too closely coupled to this growth through commodity prices and their progress now looks less sustainable. While there are still some regions of the world that can boost growth, like India, Sub-Saharan Africa and Southeast Asia, none of these represent more than a small percent of global GDP, and their progress is likely to be erratic. They simply can't move the needle meaningfully and certainly cannot replace the Chinese locomotive of the past few decades.

With respect to demographics, a combination of aging, rising life expectancy and falling birth rates means the working age population is starting to shrink, and will be 5% smaller by 2050 (United Nations). As a result, those over 65 will represent about 15% of the world population, up from about 10% today (World Bank). Fewer workers and more dependents means slower growth in the absence of productivity, which has been scarce recently. In addition, older people save more and spend less while succeeding generations, like millennials, buy less and share more. That will have meaningful repercussions in economies driven by consumer spending, like the US. In the European Union, the second largest economy as a block, demographics and the friction in the EU regulatory framework could outweigh past fruits of a common market, and the loss of one of the most dynamic participants, Britain, will be a handicap. Japan's demographic challenges have been well documented, and perhaps the BoJ's struggle, in the world's third largest economy, best demonstrates the limitations of extreme monetary policy like QE.

Quantitative easing was the post-financial crisis monetary policy weapon used to combat the threat of a deflationary spiral and depression. It worked in the US initially by stabilizing the economic base, mostly by providing economic assurance in a time of doubt and boosting financial markets. That has had an economic benefit, though the fruits have been distributed unevenly. But the beneficial impacts of QE are inherently unsustainable. Central bank balance sheets can't grow to the sky and larger purchase programs risk distorting markets. The Fed's balance sheet grew from less than $1 trillion before the financial crisis to $4.5 trillion today, 25% of US GDP. The ECB's balance sheet is approaching the same share of the Union's GDP, and they are now running out of securities that meet their criteria to buy. The BoJ, a.k.a. the "Tokyo Whale", is now a top 10 shareholder in most of the Nikkei 225 companies through its ETF purchases (Bloomberg). Their balance sheet is approaching the size of the Fed's, representing almost 90% of Japanese GDP, and yet growth has stalled.

The resulting low rates of QE policy actually may be having a depressing effect. Commercial banks, the traditional money multipliers, are under pressure due to contracting net interest margins. Business decision makers are savvy enough to know that the QE boost is short-lived and are unwilling to make long-term capital investment decisions, especially given overcapacity in a decelerating China. Individuals, especially the large and growing cohort contemplating retirement, are smart enough to know that the low discount rates

mean higher savings requirements and are even less likely to spend. At current US Treasury yields, it takes over $3 million of savings to produce $50K of retirement income. A decade ago $1 million was enough. Imagine what negative rates means for those in Japan and Europe saving for retirement! It appears low rates have hit a point of diminishing returns and may actually be functioning as an economic depressant.

One way to improve the outlook would be for political leaders and policy makers to take up more sustainable growth policies, promoting productivity growth, perhaps like those which aided US economic growth during the later part of the last century. But that does not seem probable in the current political and economic climate. Fiscal policy tools are more limited today by stretched sovereign balance sheets, the demographic issues cited above and the unintended consequences of QE; public sector liabilities rise with low rates. For instance, in the US, state and local unfunded pension liabilities have doubled over the past 10 years to over a trillion dollars…and that is based on a 7.5% assumed investment return! More realistic pension accounting puts the figure at $2-3 trillion, about 15% of US GDP (WSJ). And, the widening gap between those that have seen the benefits of the post-crisis recovery and QE stimulus and those experiencing the moribund real economy, have led to populist and nationalist rhetoric. To the extent the rhetoric becomes policy, we could see a reversal of contributors to productivity in the past, i.e. trade liberalization and globalization.

And, the current environment looks more prone to events that would make financial markets more volatile. To the extent growth is lower, exogenous events can more easily tip the trajectory of growth into negative territory and recession. There will be greater sensitivity to potential Brexit impact on Europe, the latest US employment report and data points out of China. The current low base of interest rates inherently leads to more volatility as any wiggle up will have a dramatic impact on discounted future values. And, despite recent assurances from Jackson Hole, the aggressive use of monetary policy like QE over the past few years has left central bankers less ammunition to fight future economic weakness or buffer market volatility. And, the political response to a populace hungry for growth in the real economy and demanding a return to the "good old days" could lead to more extreme policies like large unfunded stimulus packages, "helicopter money" as well as closing of borders and waging of trade wars.

So, the post-QE era will be one characterized by low growth, low yields and greater economic and political volatility. What is a long-term investor to do? We know what one should have done over the past decade, pile into high quality sovereign fixed income. But that seems to have run its course with the top probably being formed today by the central bankers' purchases under QE. Now it appears that asset class is "risk, return free". Perhaps corporate debt or good dividend paying equities can deliver mid-single digit returns from here, but that also has been popular with record fund flows and relatively high valuations. And, one must mind the quality and sustainability of those coupon and dividend streams, especially as we are due for recession.

For long duration assets, we recommend investing in sustainable growth companies, businesses that can grow sales predictably at a rate exceeding global GDP growth, operate efficiently and deliver free cash flow that will grow in the double digits. The trouble is, one must be creative in research as they are hard to find in the current environment. We find them today in the REIT sector, managing datacenters, in healthcare implementing electronic medical records, delivering infrastructure and software as a service in technology, providing mundane payroll and payment processing and nurturing global brands. If one can track down these businesses and assemble them in a portfolio, using volatility as the opportunity to acquire at good prices, the resulting "growth bond" should be quite valuable in the current investment environment. As investors recognize the uniqueness of their sustainable growth in the post-QE world of unsustainable economic progress, valuation should improve.

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